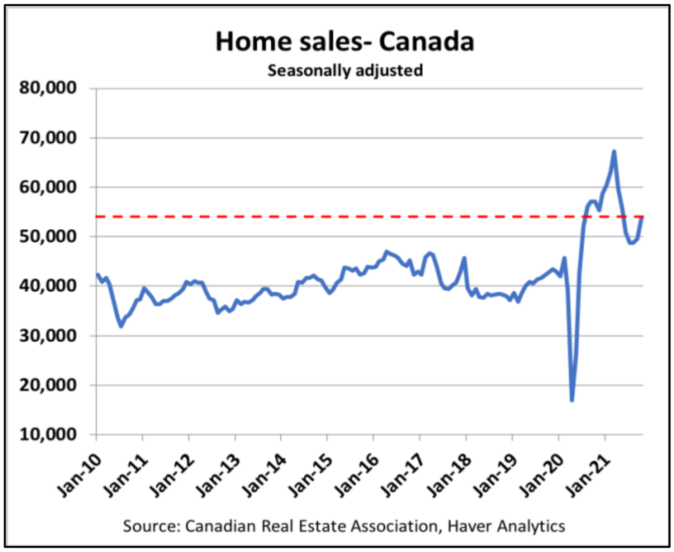
Special report:
The state of play and the year ahead

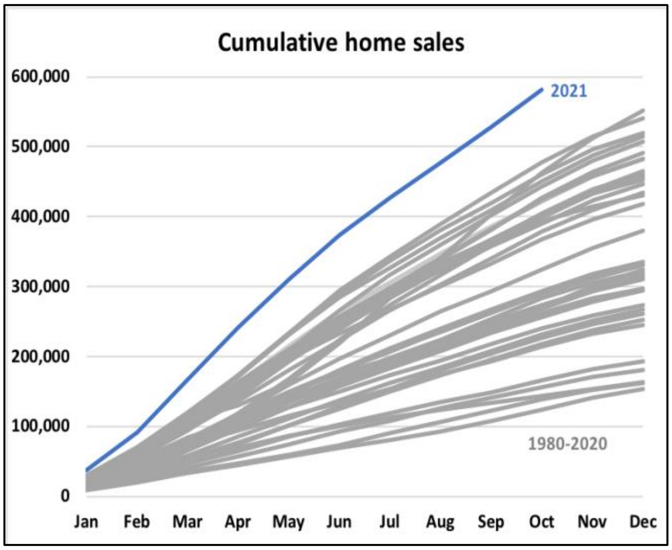
Quick links:

PART 1: The state of housing and the economy

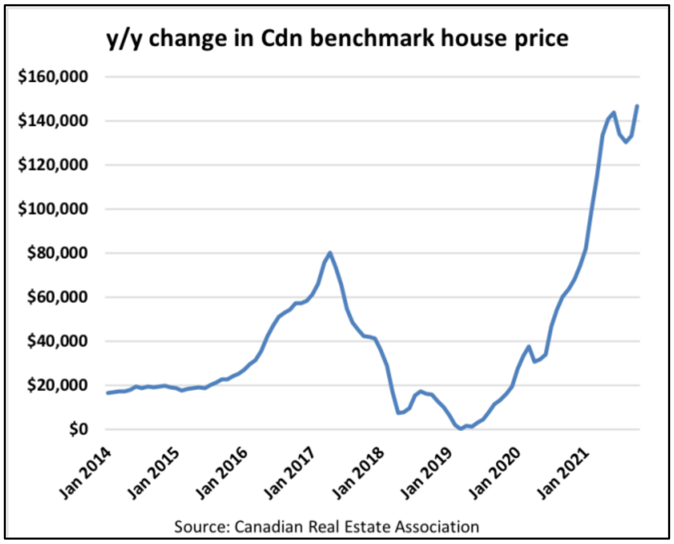
1) Housing records smashed in 2021

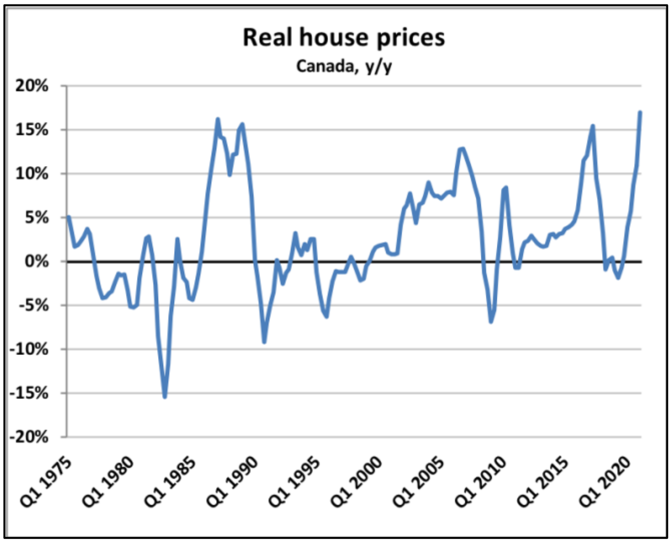
Home sales remain nearly 40% above decade norms and have already set an annual record with 2 months still to go:





The value of the typical home in Canada rose by nearly $150,000 y/y in October. Real house prices hit 50-yr highs earlier this year:



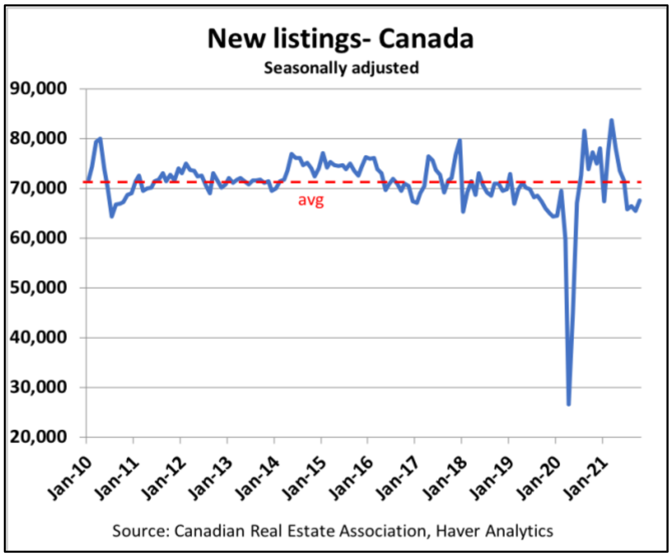


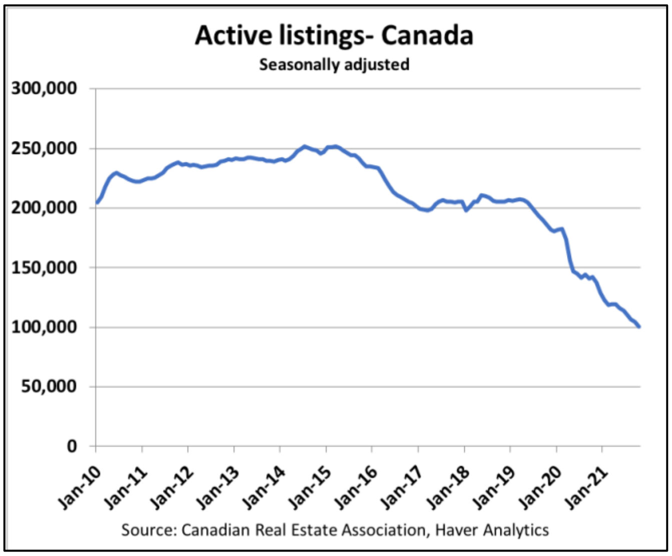
To frame just how much prices have risen, consider that a 20% correction from current levels would only put values back to September 2020 levels:

Price correction from Oct 2021 levels	New price	Last seen	Time since last seen
10%	$693,000	Mar 2021	7 months
20%	$616,000	Sep 2020	1 year, 1 month
30%	$539,000	Mar 2019	2 year, 7 months

2) Resale supply continues to plunge

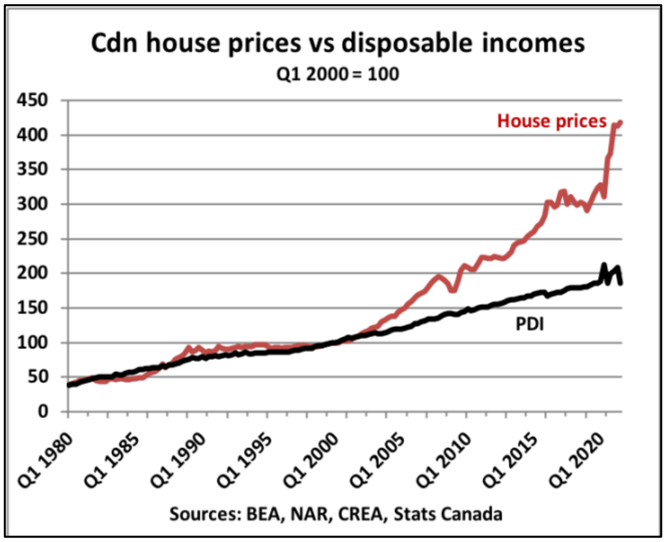
The flow of new listings remains well below decade norms. Active listings nationally have fallen by 50% since the beginning of 2019:

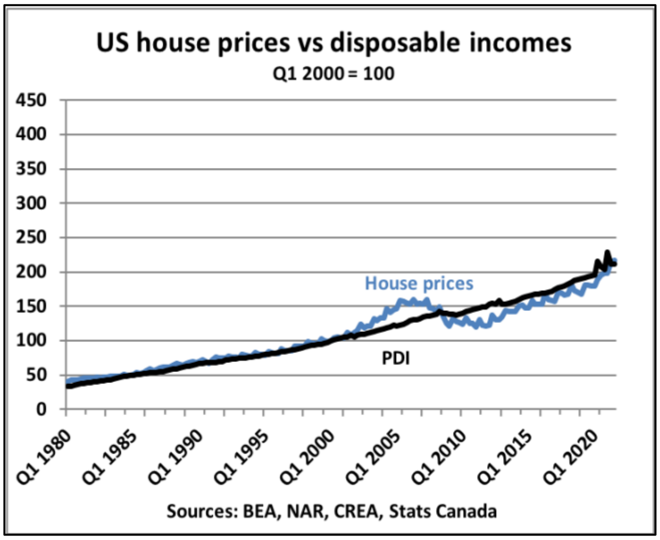




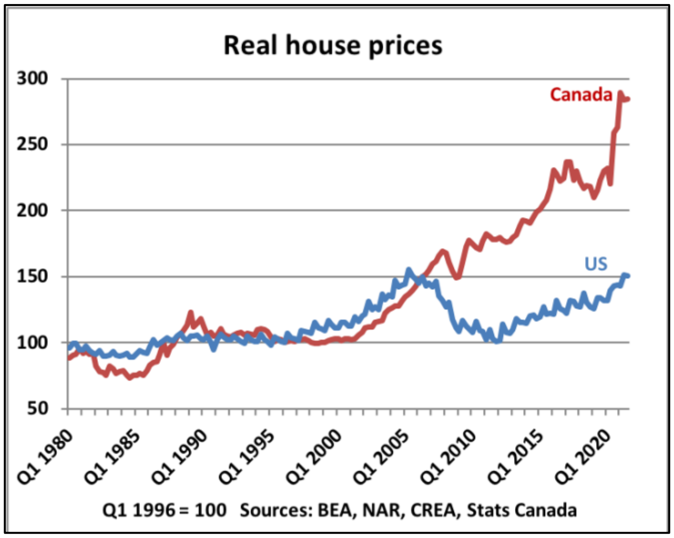
3) Housing valuations hit absurd levels

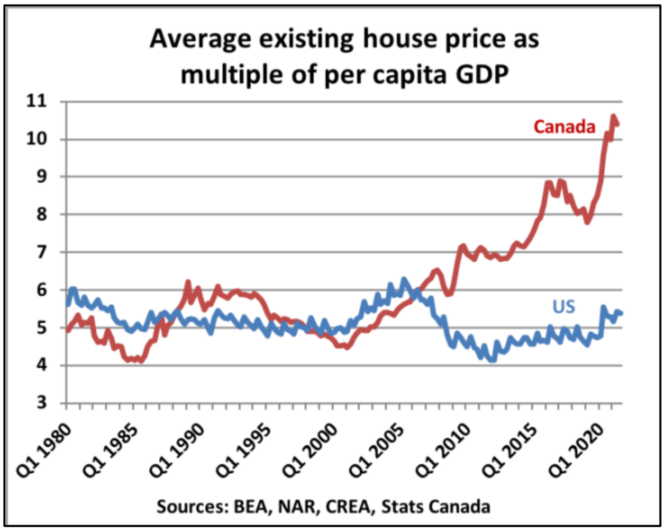
House prices continue to disconnect from disposable incomes. The charts below the magnitude of the divergence in Canada relative to the US:



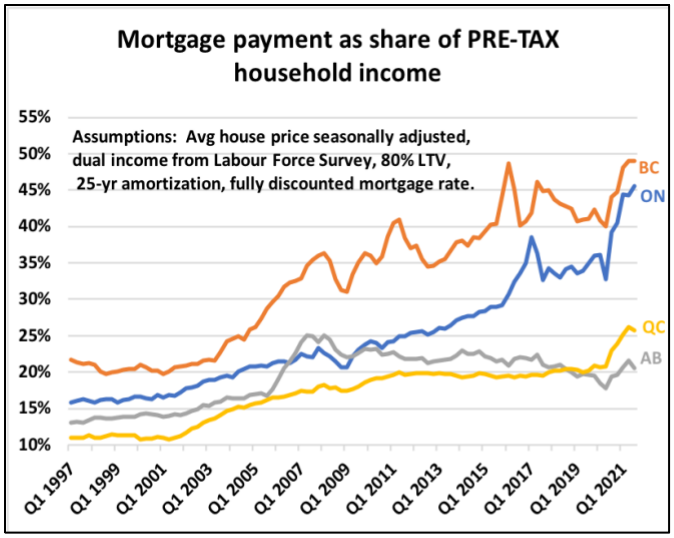


Real house prices and prices as a multiple of per-capita GDP also at records:



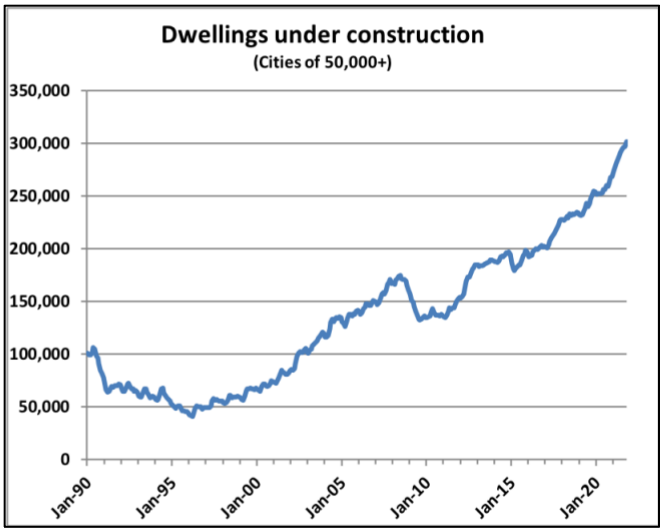


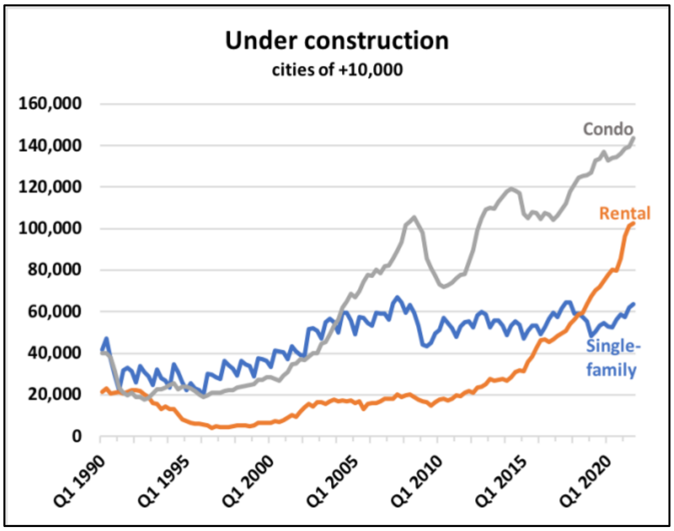
Affordability is stretched, notably in BC and Ontario….much less so in Alberta where carrying costs as a share of incomes are below where they were 15 years ago:



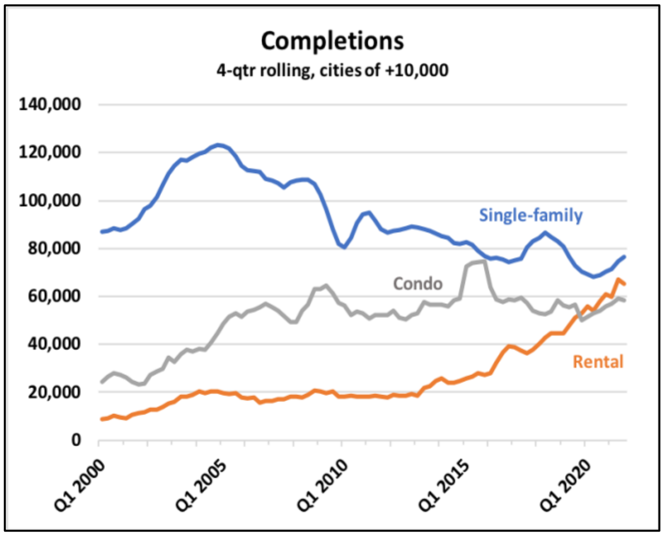
4) Lots of new supply coming, but not enough single-family

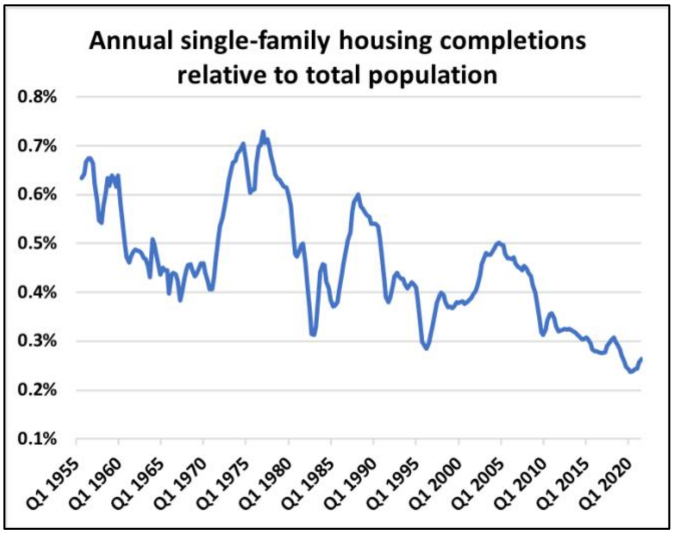
Dwellings under construction are at a record, but increases are due entirely to condos and the purpose-built rental segment.





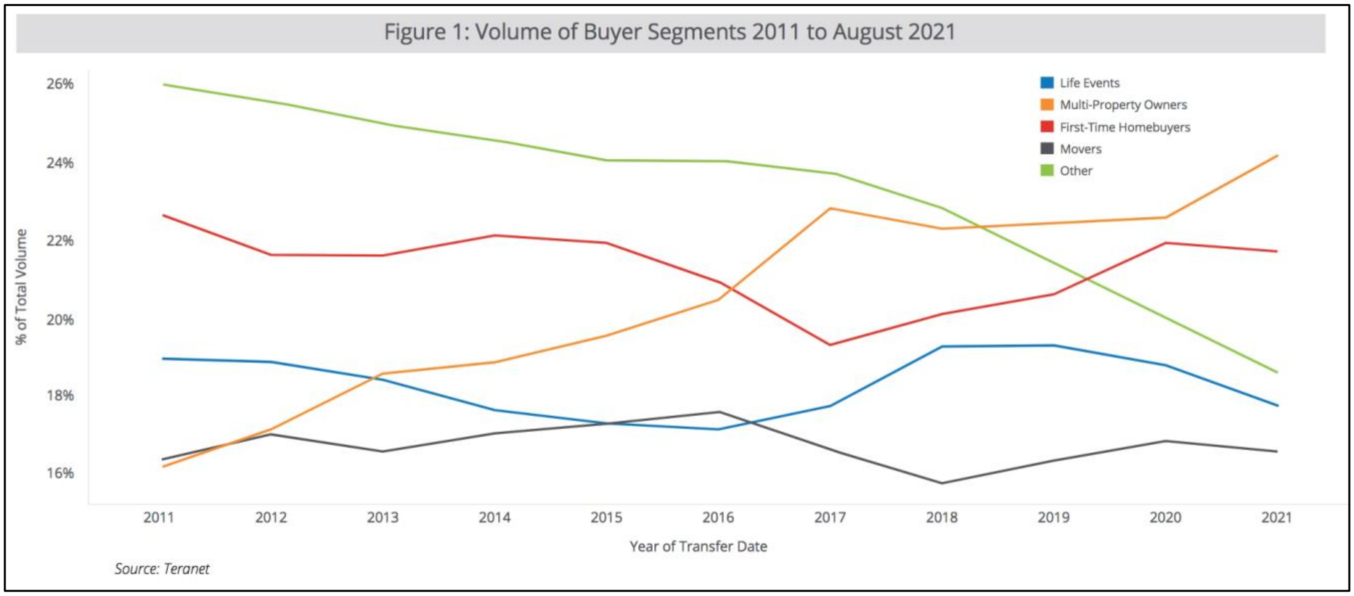
Completions of single-family dwellings rose only modestly in 2021 and remain well below levels seen in the mid-2000s. Relative to total population, annual single-family completions are near the lowest levels on record:





5) Investors taking over

Multi-property owners, including investors and buyers of recreational properties, now make up a quarter of all home sales in Ontario according to land registry data from Teranet. It was 16% a decade ago. Based on my calculations, that means that this group has accounted for just under half of the increase in home sales over the past decade:



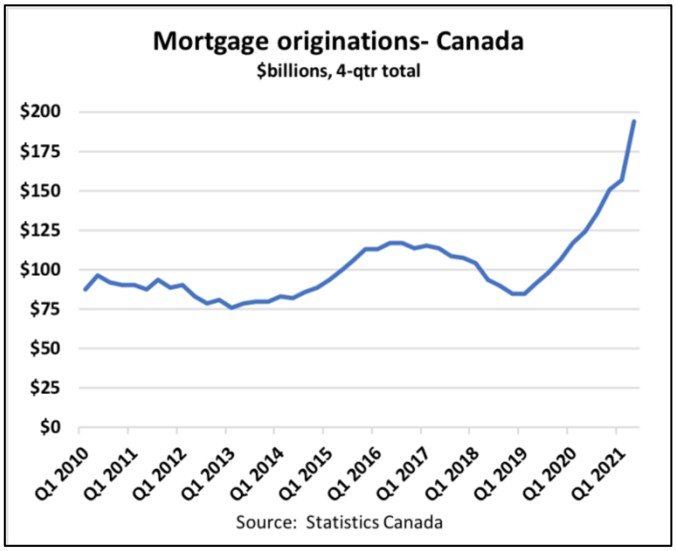
This dynamic wasn't lost on the Bank of Canada. Deputy Governor Beaudry noted the following in a speech in late November:

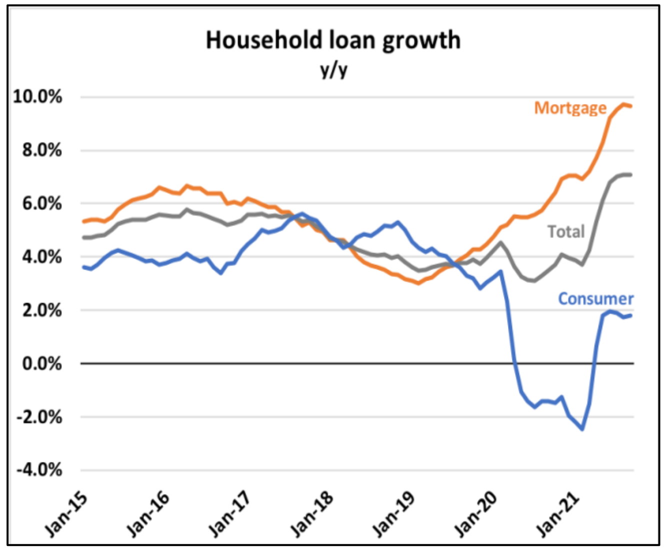
> *A sudden influx of investors in the housing market likely contributed to the rapid price increases we saw earlier this year. In such a case, expectations of future price increases can become self -fulfilling, at least for a while. That can expose the market to a higher chance of a correction.*

Regulators are increasingly focused on this dynamic, and I think we'll see them move to tighten financing early next year.

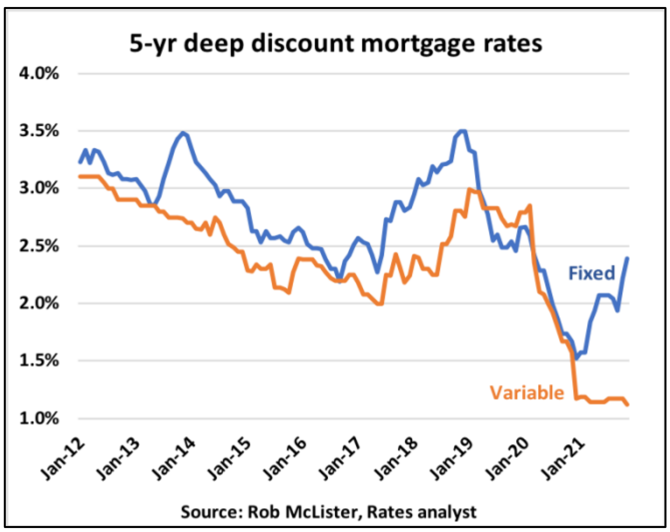
6) Huge surge in mortgage credit growth as bank underwriting "deteriorates"

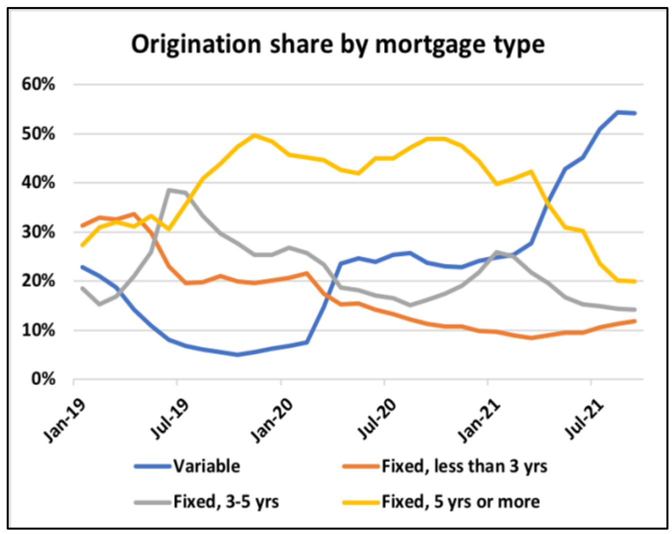
Mortgage originations have hit nearly $200B in the past 4 quarters, more than twice the level seen in 2019. Mortgage growth is approaching 10% y/y:



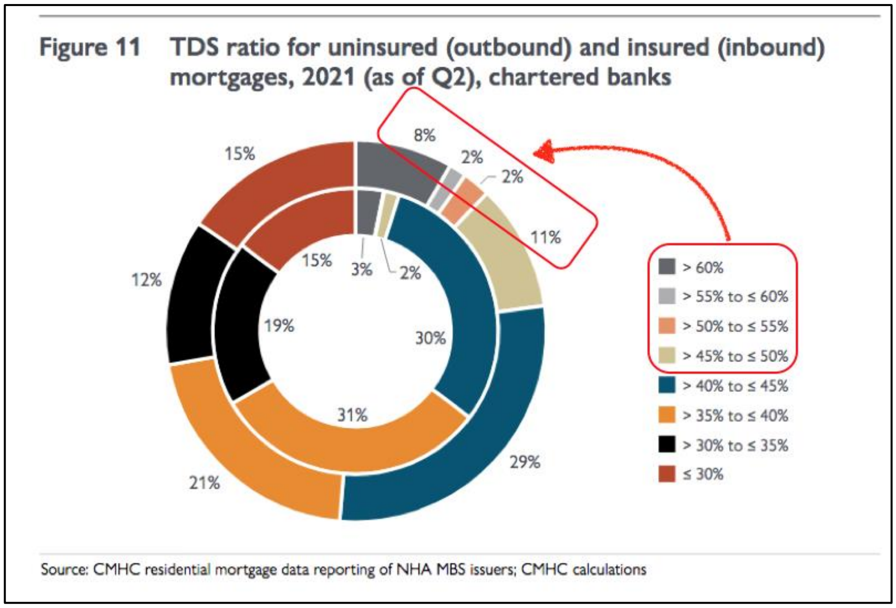


Variable rate mortgages are priced substantially below fixed rate products. At 130bps, the fixed rate premium over variable is the highest in 9 years. Consequently, borrowers are plowing into variable mortgage products, which now account for 54% of new originations compared to 5% in 2019:





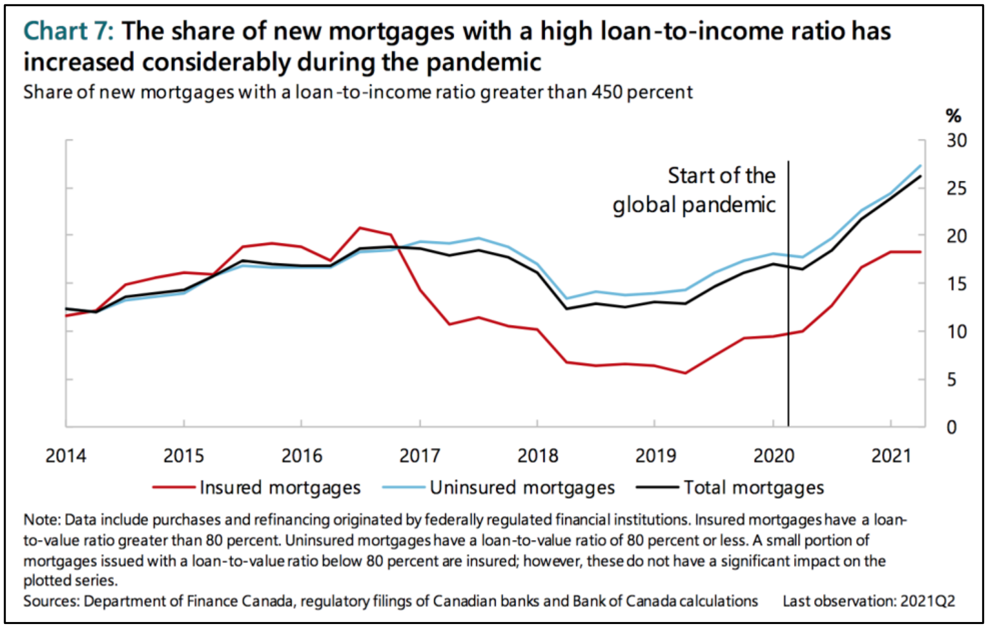
Uninsured mortgages at chartered banks were up 19% y/y in September. Banks are increasingly granting debt service ratio exceptions to help qualify borrowers and effectively soften or bypass the stress test requirements. CMHC data shows that up to June of this year, 23% of new uninsured mortgages issued by chartered banks had total debt service (TDS) ratios above 45%, and 8% were above 60%. Official TDS limits are 44%:



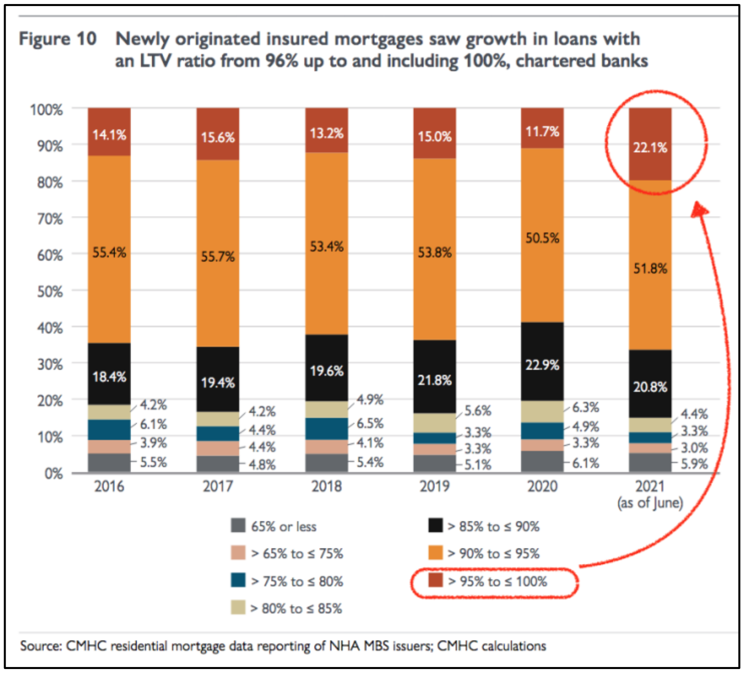
A recent presentation by the Bank of Canada also highlighted the "deteriorating quality" of new mortgages, as evidenced by a rising share of new loans to "highly indebted" households":

> *[…] we also found that the deteriorating quality of new mortgage borrowing during recent quarters is now likely the bigger driver of household indebtedness.*

> *[…] The takeaway is that, overall, vulnerabilities linked to elevated household debt appear to be rising again after a slight pause.*

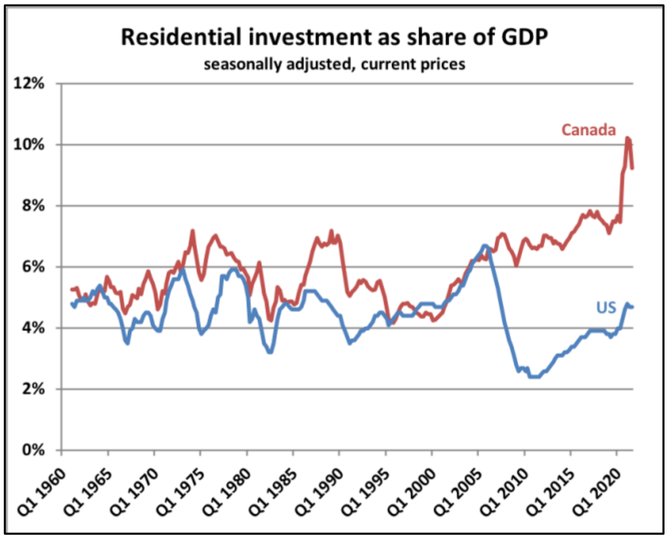


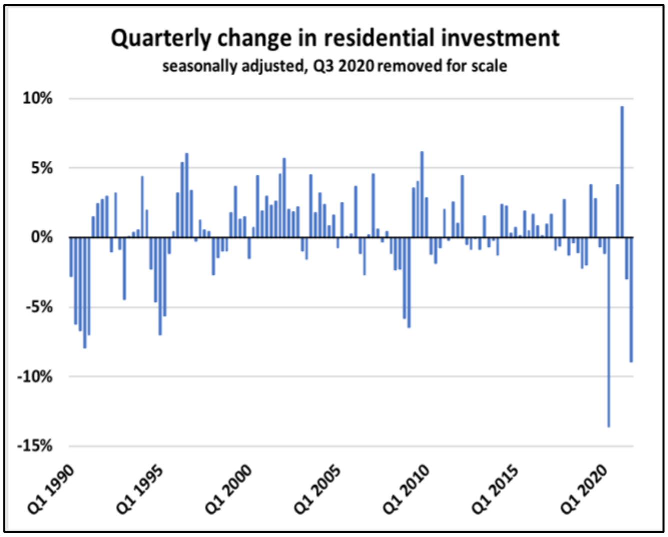
Finally, CMHC data shows the share of new insured purchases with LTVs of 96%-100% at origination has jumped to 22% from less than 12% in 2020:



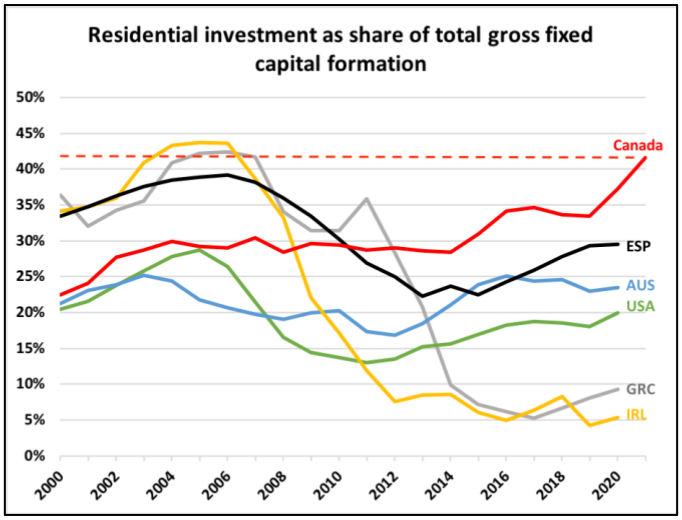
7) Housing is cannibalizing the economy

Residential investment remains over 9% of GDP in Canada in spite of plunging at a 31% annualized rate in Q3, the second steepest drop in the past 30 years:

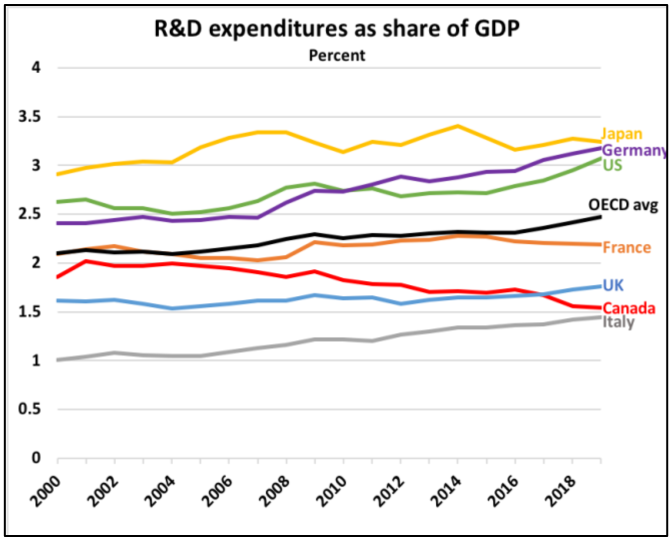


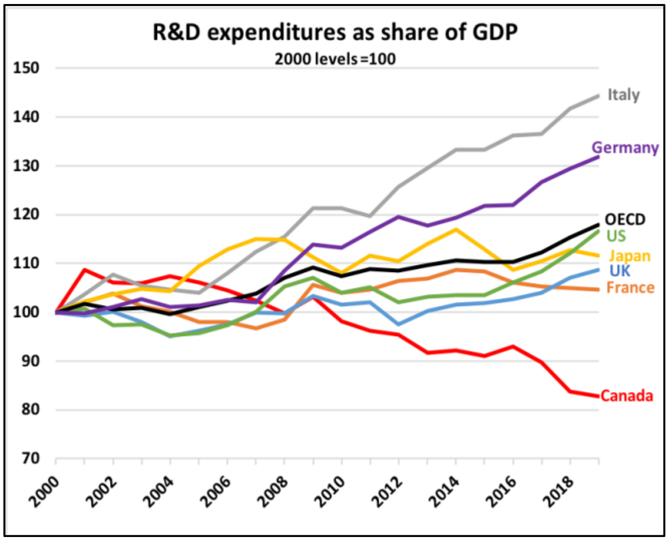


Housing continues to cannibalize the economy. So far in 2021, it has accounted for nearly 42% of total gross fixed capital formation. That level has only been hit by a couple OECD countries in the past 20 years, namely Greece and Ireland at the height of their respective booms:



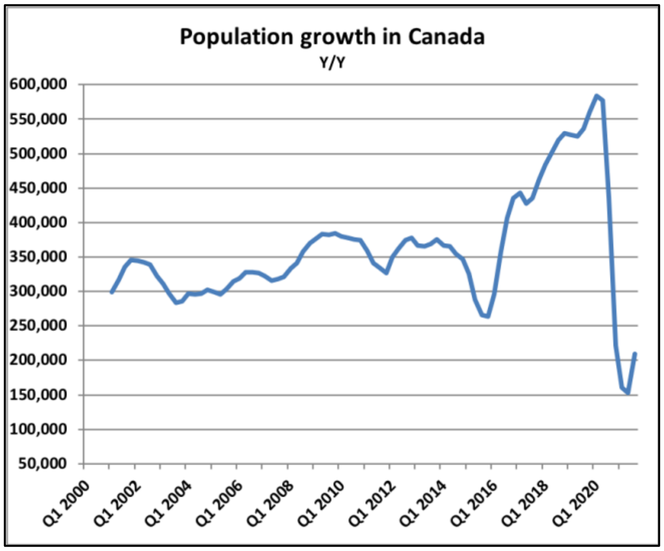
In part this is due to very strong residential investment, but it's also a function of weak business investment, which bodes poorly for future productivity gains. Among OECD countries, Canada ranks near the bottom in terms of R&D expenditures relative to GDP, and it's the only country that has seen that figure decline since 2000:



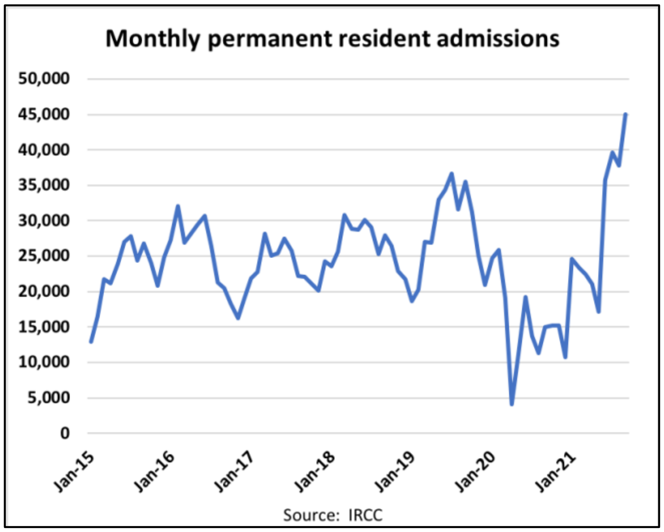


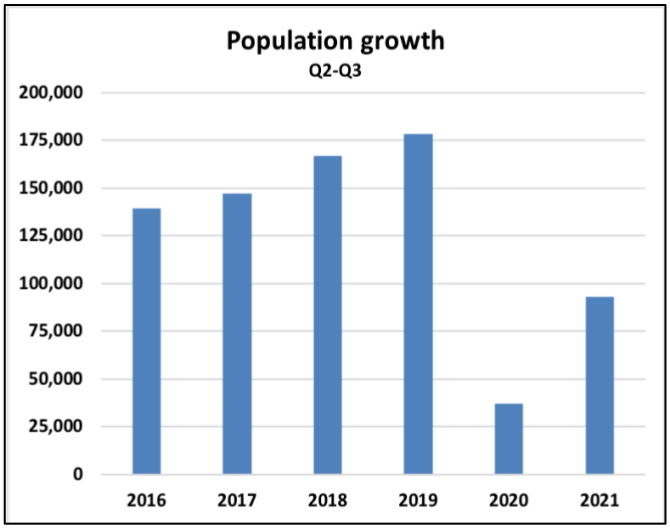
8) Population growth is firming but nowhere near 2019 levels

Population growth has rebounded off the pandemic lows but is still running at barely 1/3 of prior levels:



Even with permanent resident admissions hitting the highest levels in 100 years, total population growth increased by “just” 93k in Q3, well below normal levels for that quarter.

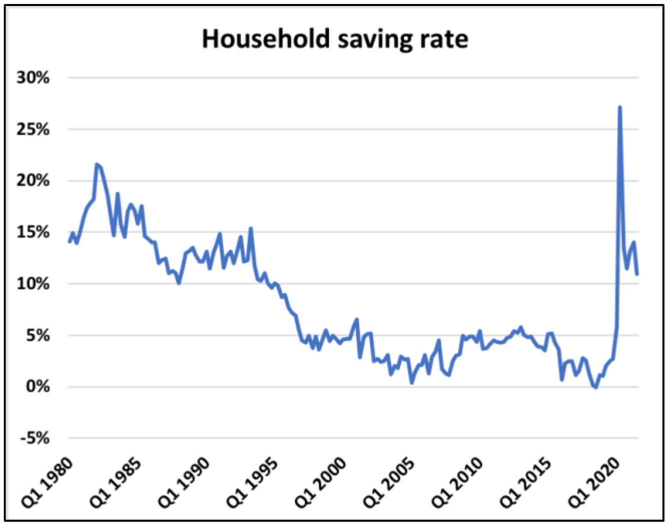


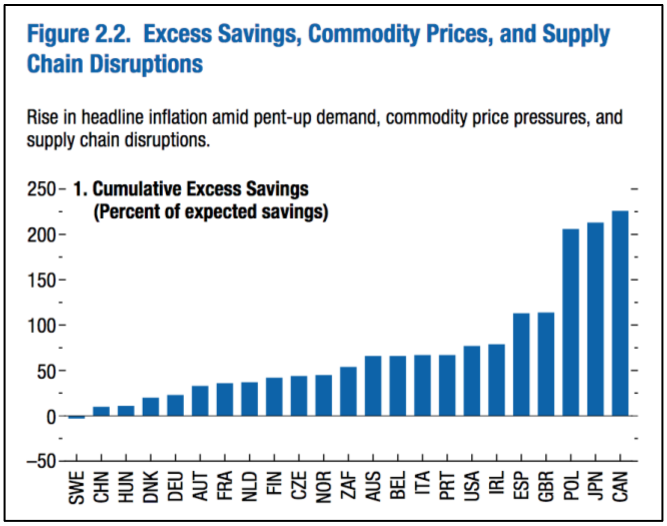


This is primarily due to the fact that the majority of new permanent resident “admissions” are actually conversion of non-permanent residents such as international students and work permit holders. Those individuals are already counted in the total population.

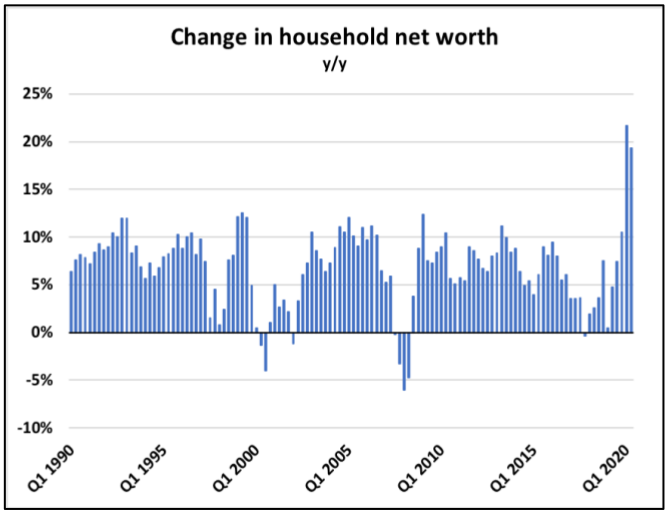
9) Consumers balance sheets, debt servicing capacity look good

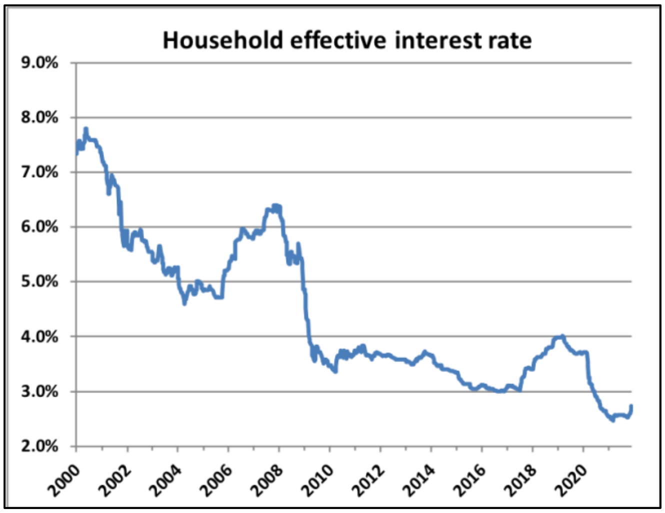
Consumers remain in very good shape overall. The savings rate was still in the double digits in Q3 while excess savings are now in the $250B range, equivalent to 10% of GDP. That puts Canada at the top of the heap globally in terms of excess savings according to the IMF:



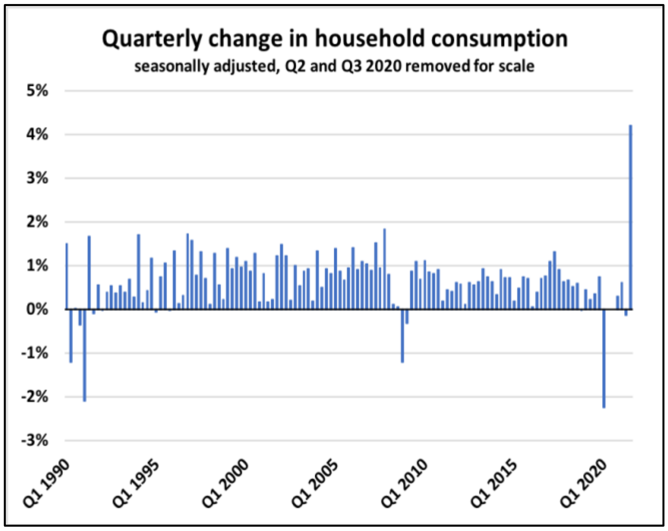


Household net worth continues to grow at nearly a 20% annual rate, and debt servicing expenses are still way below pre-pandemic levels. The household effective interest rate, while back on the rise again, still remains 100bps below where it was in early 2020:





Household consumption surged in Q3, posting a massive 17.9% annualized increase. Outside of the lockdown bounce in Q3 2020, that is the single best quarterly showing in the past 30 years:



10) Insolvencies stuck at 20-year lows

There are virtually no signs of stress in consumer credit. Insolvencies remain roughly 1/3 below pre-pandemic levels while credit card trust payment rates are at all-time highs and delinquencies at the lows:

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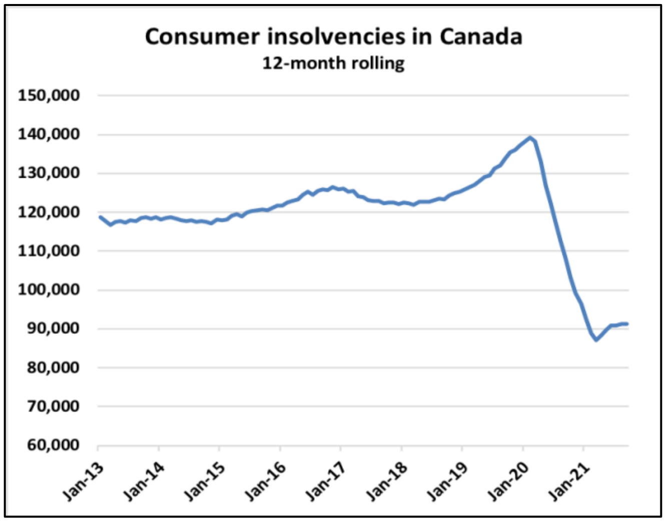
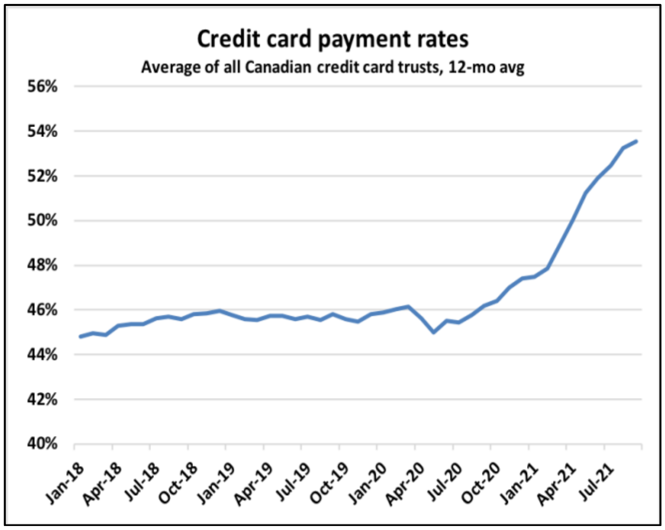
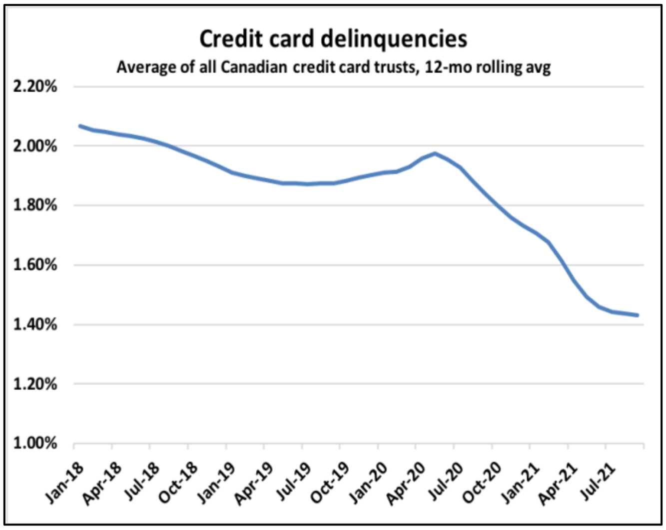




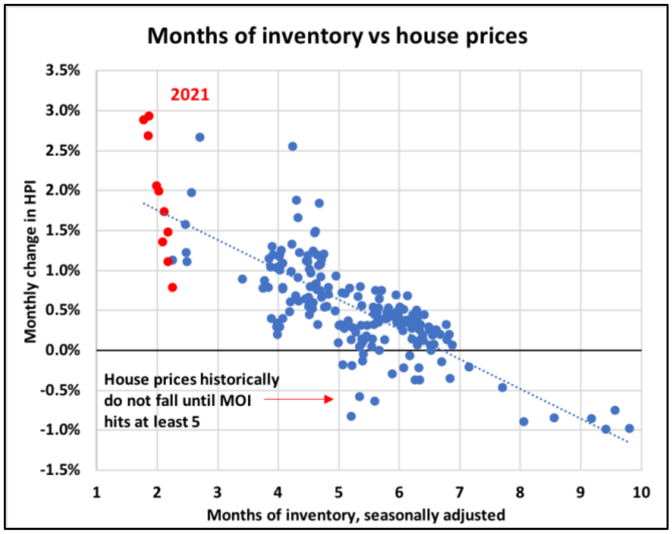


PART 2: Predictions for 2022

1) Housing continues to squeeze higher until at least H2 even as sales fall y/y

The likely path for house prices is substantially higher for at least the first half of 2022. Months of inventory are less than 2 currently….one of the lowest readings on record. Prices do not begin to fall until that measure hits AT LEAST 5, and usually closer to 6.

In other words, we can double inventory from current levels AND cut sales volumes by 1/3 and the market would barely be balanced.



This speaks to just how absurdly tight this market is currently. It's extremely unlikely that we'll see sales levels surpass 2021 levels next year, but with inventory so low in most parts of the country, it won't matter. Barring a very significant shock, the market should move higher until at least the second half of the year.

2) Regulators will clamp down on investors in early 2022

One dynamic that could disrupt the market is a significant intervention on the part of regulators. Consider some of the comments from the past couple weeks:

> *"What worries me is the role of speculative type investors and the kind of market we have seen over the last year […] Prices are going up, and investors that are speculating on the increase in price are adding to the demand pressures because some of them are buying these homes […] it adds extra froth to the market, pushes home prices higher and can create a harder landing if and when the market turns and prices correct"*
>
> -Bob Dugan, CMHC Chief Economist, quoted in the Globe and Mail, Nov 25

> *"[…] Our analysis finds that many Canadians are buying homes as investment properties—that is, in addition to their principal residence—and the importance of this phenomenon has grown. Expectations of a capital gain can make homes a very attractive asset for investors.*
> *[…] A sudden influx of investors in the housing market likely contributed to the rapid price increases we saw earlier this year. In such a case, expectations of future price increases can become self -fulfilling, at least for a while. That can expose the market to a higher chance of a correction.7 And, if one occurs, the damage can spread far beyond the investors.*
>
> -Bank of Canada Deputy Governor Beaudry, speech on Nov 23

It's clear that investors and second property owners broadly are in the crosshairs. Expect OSFI to target them via one or several of the following:

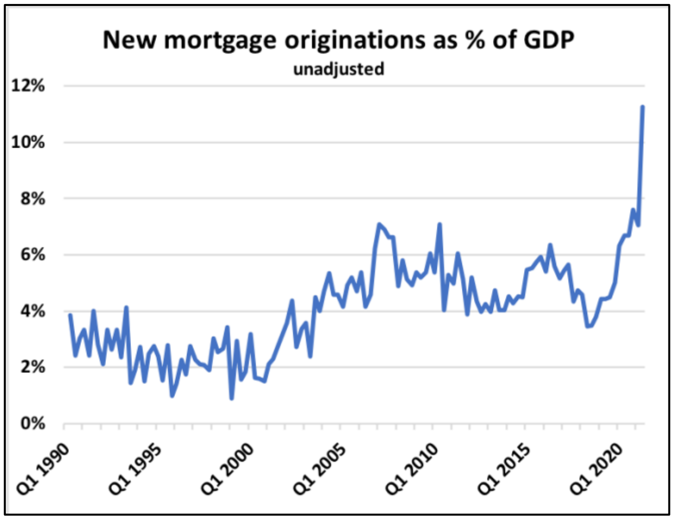
- Higher down payment requirements on secondary properties. Currently 20% min, could be changed to as high as 35%.
- Prohibit the use of any borrowed funds as down payment, including HELOCs/refis off primary residences and gifted down payments where the source is borrowed funds,
- Higher risk weighting for mortgages on non-owner occupied homes.
- Fewer maximum "doors" per borrower.

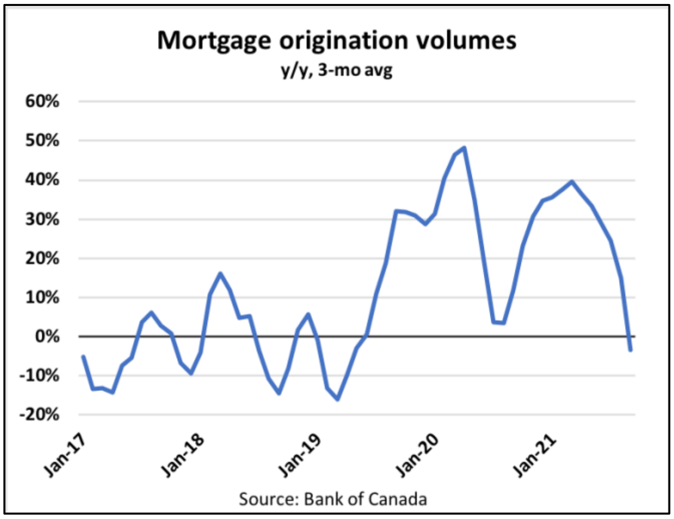
This could have quite a material effect on demand and would go a long way to removing speculative froth from the market. It would also disproportionately hurt the likes of CIBC which has seen uninsured mortgage growth surge to 23% y/y recently on the back of a major push into rentals….the loan segment that coincidentally got them in trouble with OSFI back in 2017.

Based on recent comments regarding "deteriorating underwriting" as evidenced by rising prevalence of high loan-to-income borrowing, there's a chance that OSFI may also add a debt-income limit to the stress test and could also target HELOCs by either forcing banks to include any undrawn portion in debt service ratio calculations.

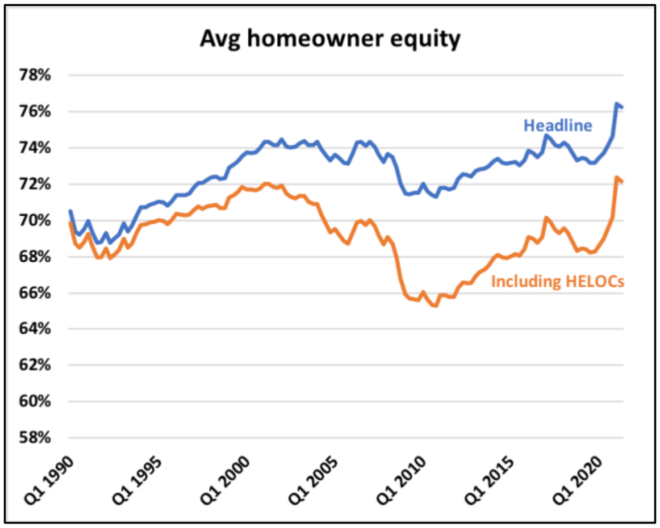
3) Mortgage credit growth will slow, consumer credit accelerate

Mortgage credit growth should slow sharply next year as we begin to lap record originations in Q2. Back then they hit the equivalent of 11% of GDP...nearly double any prior peak. Already origination volumes are falling relative to last year, and that trend should accelerate as we move through 2022:

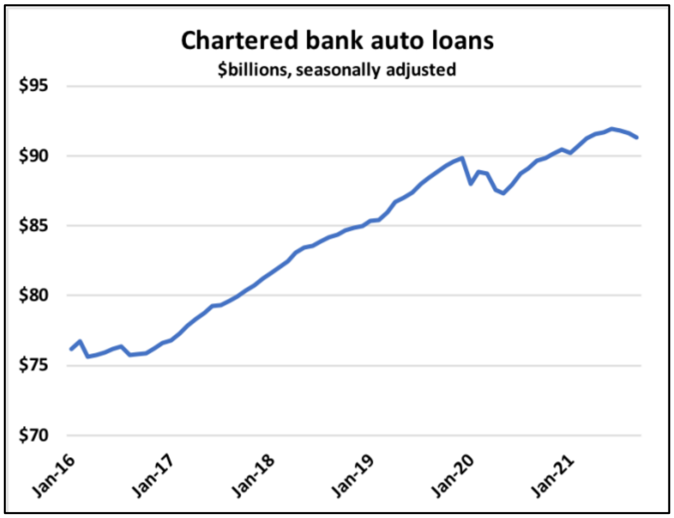


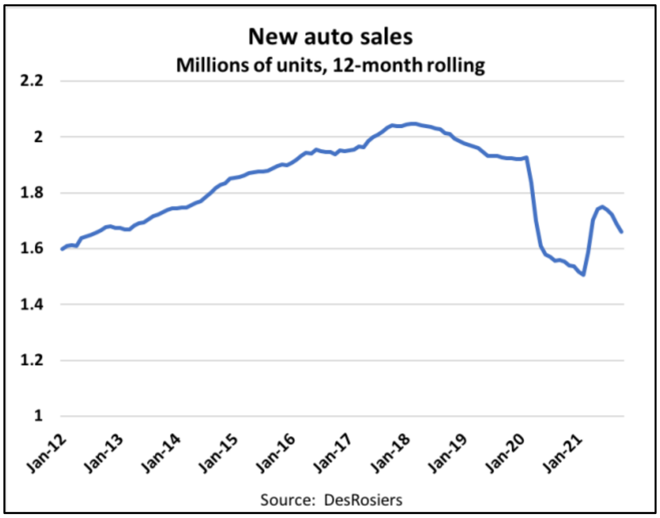


Conversely, it should be a solid year for consumer credit. HELOCs (which are classified as consumer loans in Canada) are seeing accelerating loan growth with total balances now up nearly 5% y/y. That doesn't sound like much but it's the strongest growth rate since 2019. And with consumers still sitting on record home equity levels, there's plenty of room for this to expand further:

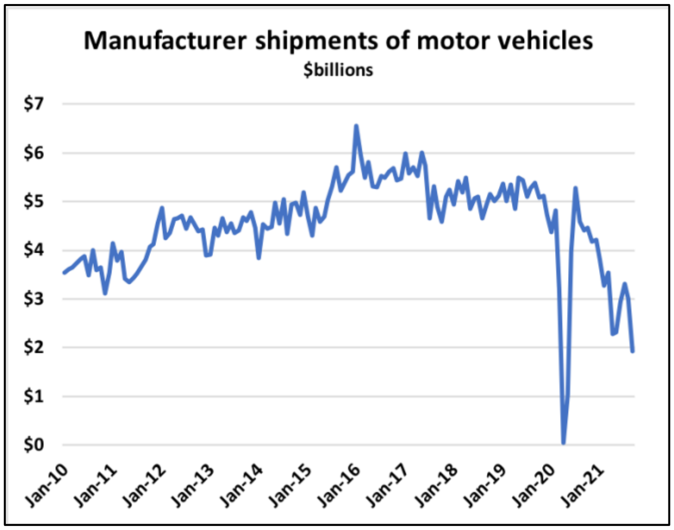


Auto loans have been flat since March 2021 and have fallen over the past few months. Chalk this up to weak auto sales in Canada as dealers remain constrained on new inventory:

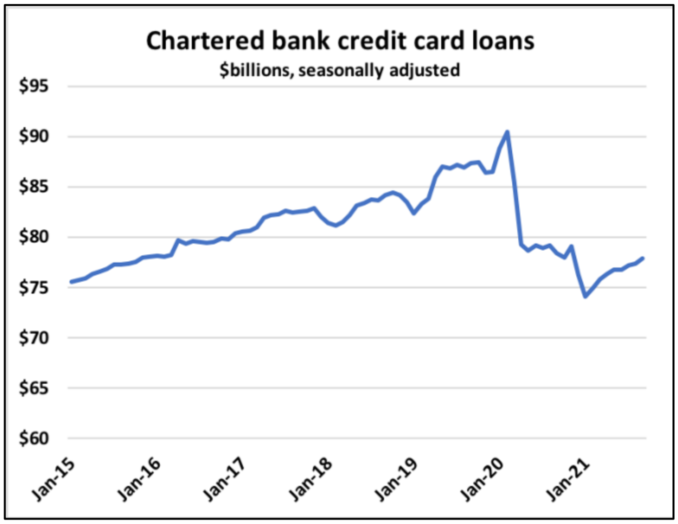




It's really hard to envision auto production getting any worse from here. Manufacturer shipments plunged 35% in September. Outside of April and May 2020, this is the lowest level of output in the nearly 30 years of data. But with some tentative signs that chip shortages and shipping delays are easing, there's reason to think things should begin to improve early next year:



Finally, credit card balances look set to rise sharply next year. They remain 14% below Feb 2020 levels on a seasonally adjusted basis but have been creeping back up in recent months. And with savings growth slowing and federal income support measures running off, I'd expect a solid increase in card balances in 2022:

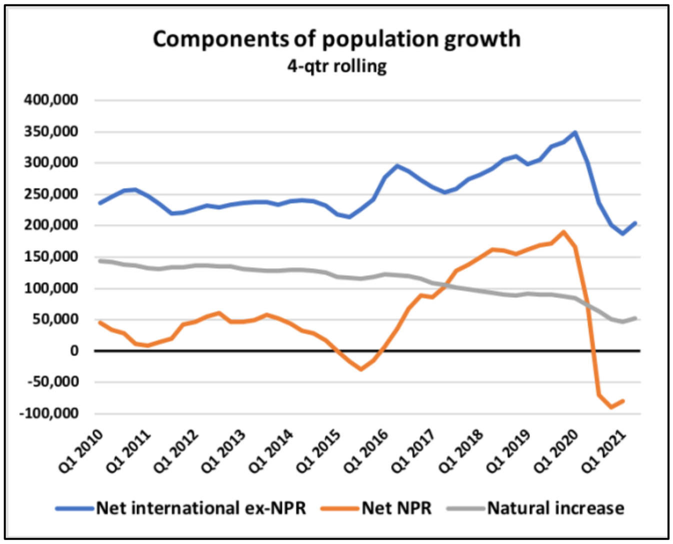


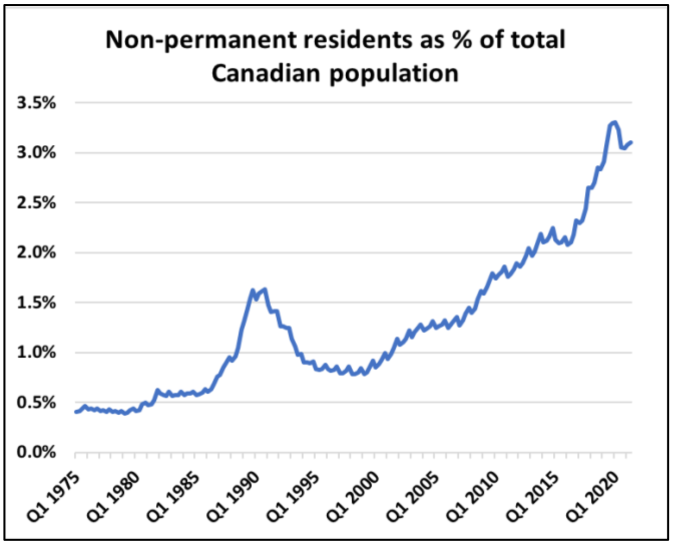
4) Population growth will remain well below 2019 levels

Contrary to popular belief, Canada's total population growth is unlikely to be anywhere close to the 600k y/y peak from late 2019. Back then we had a huge surge in non-permeant residents, which added nearly 200k to headline population growth. Post-secondary institutions were aggressively expanding seats for international students at the time, a trend that is unlikely to be replicated.

Today there's a growing trend toward virtual classes and online learning at higher education institutions which means international students can complete certain programs entirely remotely. Couple that with a more welcoming environment in the US under the Biden administration, and it will likely be many years before we see peak growth in that cohort.

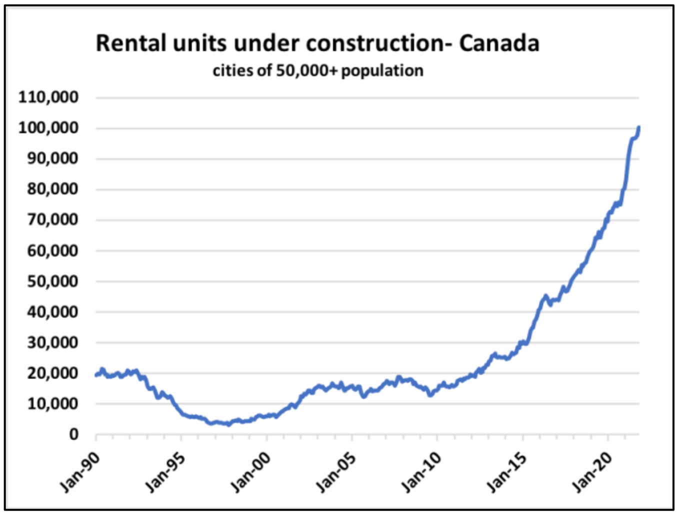
It's also important to remember that non-permanent residents are a notoriously volatile and pro-cyclical component of population growth. The fact that NPRs still represent a nearly unprecedented 3.1% of the total Canadian population suggests that it's unlikely we'll see a material increase from here.

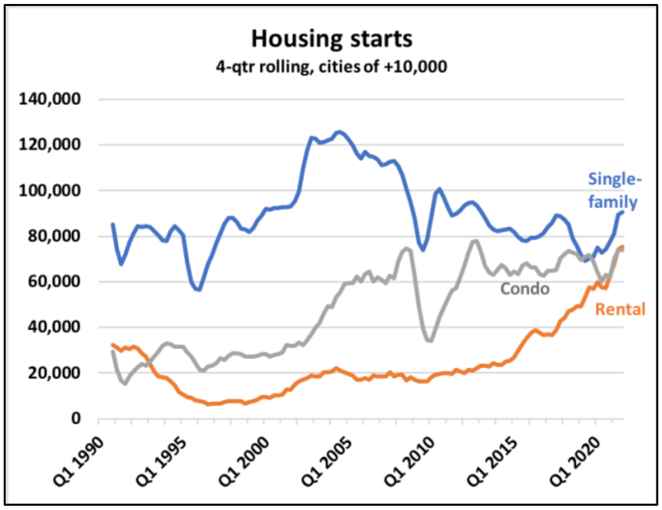




5) Rental market will soften across the country, notably in Alberta

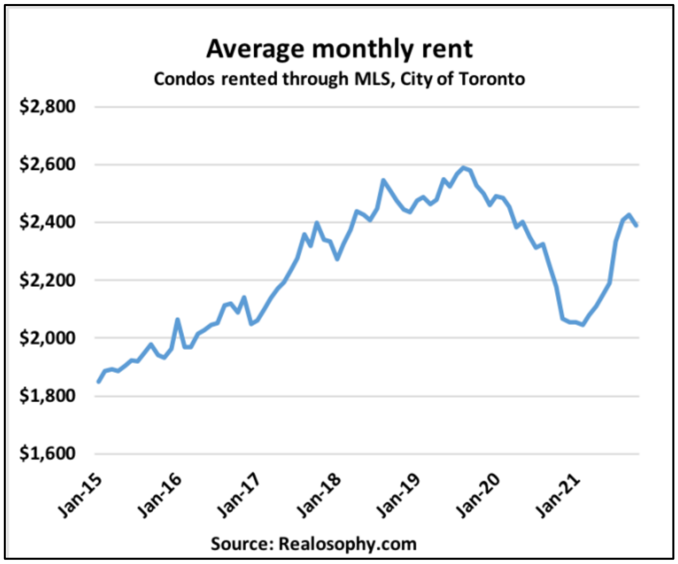
Canada recently crossed 100,000 rental units under construction for the first time in at least 30 years….a 5x increase in the past decade alone. For the first time since the early 1990s, rental housing starts and completions are higher than condos:



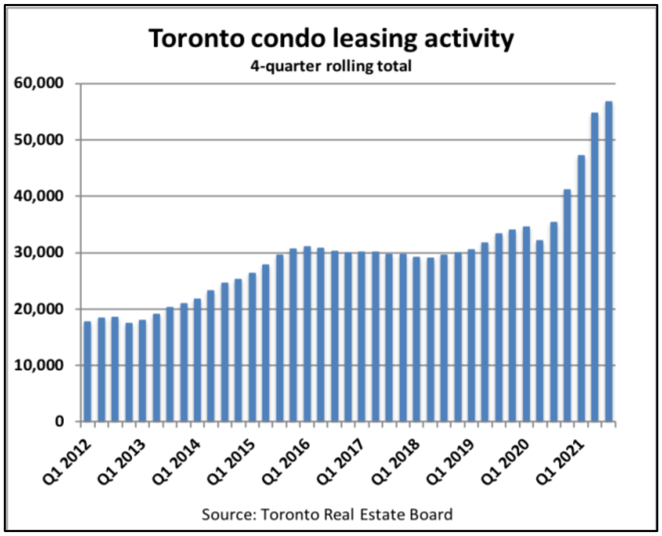


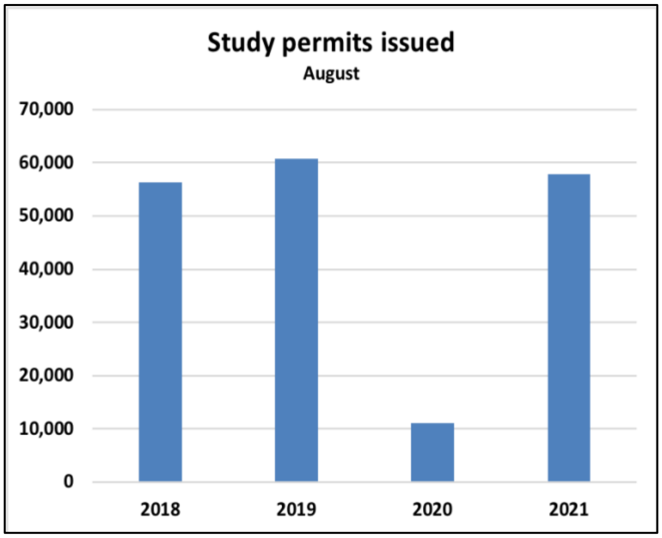
Construction in the rental segment is booming, and it brings me back to a point I've made before: If there's potential overbuilding in the Canadian housing market, it's probably in the rental space or condo space as opposed to single-family.

Let's zoom in on Toronto for a moment. Interestingly condo rents declined slightly last month, but there's unquestionably been a dramatic tightening in that market since the lows in late 2020:



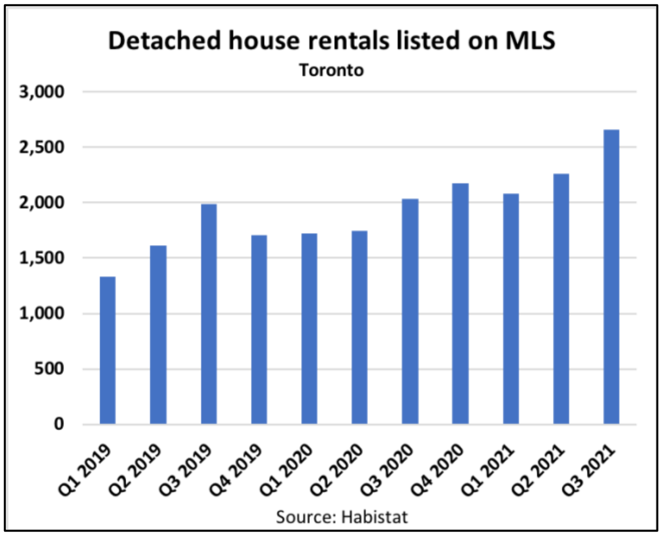
In Q3 we had a massive surge in rental demand, largely because of the 5x increase in study permits issued this summer relative to 2020 which led to a near doubling in leasing activity:



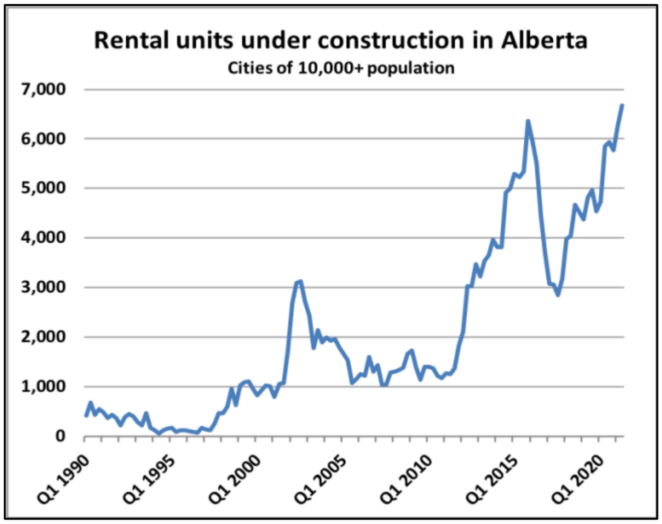


But even with that one-time boost from returning students, the lease-list ratio (a measure of demand relative to supply) remains below where it was pre-COVID.

As we move into 2022, I expect the rental market to remain softer than before the pandemic, in part due to widespread investor participation across housing types. It's not just condos anymore. Detached houses are increasingly being listed for rent also:



While it's hard to find a part of the country that hasn't seen a huge runup in rental construction, one area to watch is Alberta. Rentals under construction have now surged past the 2015 highs:



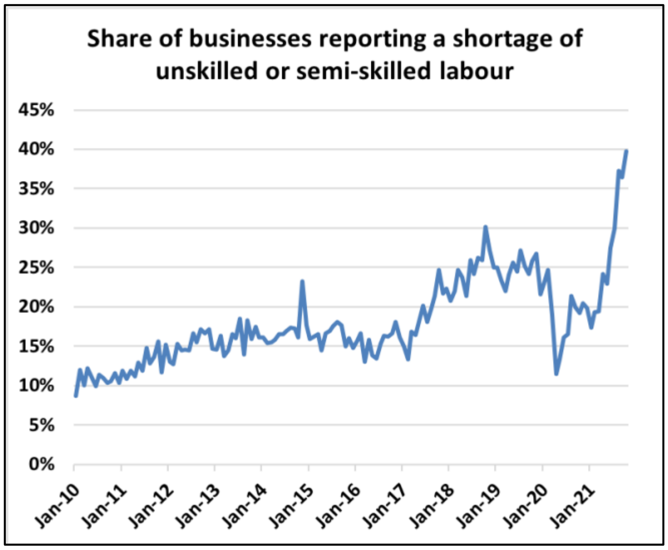
In addition to record supply, we'll likely see demand pulled away from the rental space into the ownership pool. Condo prices are flat over the last 15 YEARS in Calgary and are more affordable on a carrying cost basis than they've perhaps ever been. I don't believe there's a single other top-20 metro in the country that has seen any housing segment get MORE affordable over the past few years.

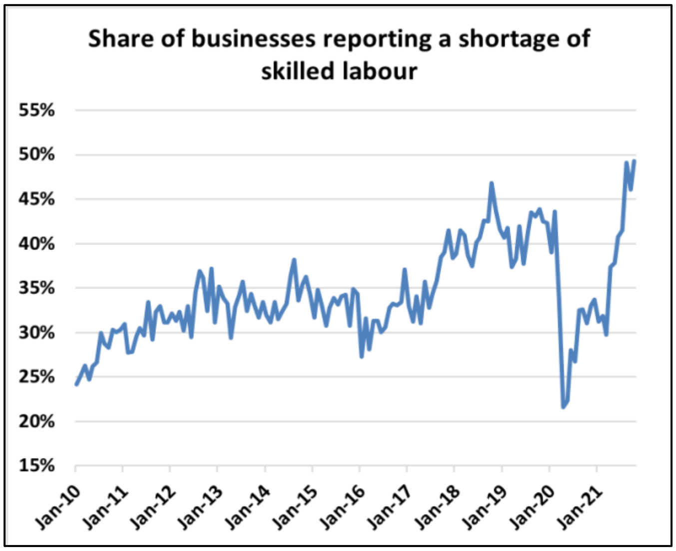
Keep an eye on occupancy rates at Boardwalk REIT. Edmonton accounts for 36% of NOI and has seen same-property occupancy rates fall from 95.5% in Q3 2020 to 94.9% last quarter in perhaps an early sign that the rental market is rolling over.

6) Unemployment rate will hit record low, workers will see strong wage growth

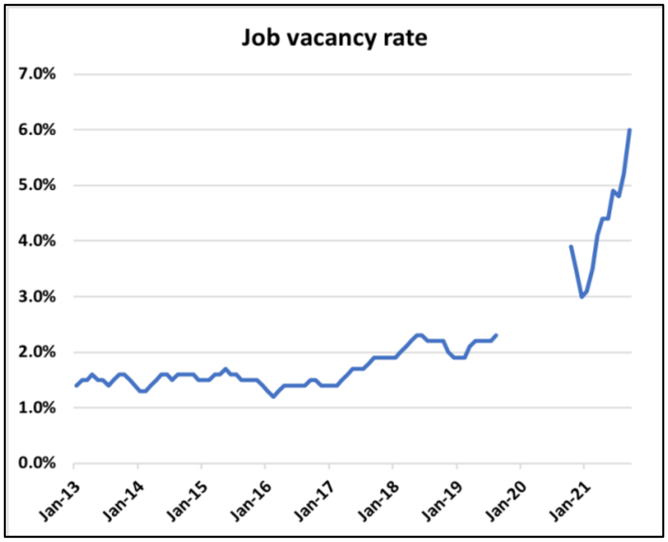
Let me lay out a few facts here:

- CFIB's monthly member survey shows a record share of businesses reporting a shortage of both skilled and unskilled labour:

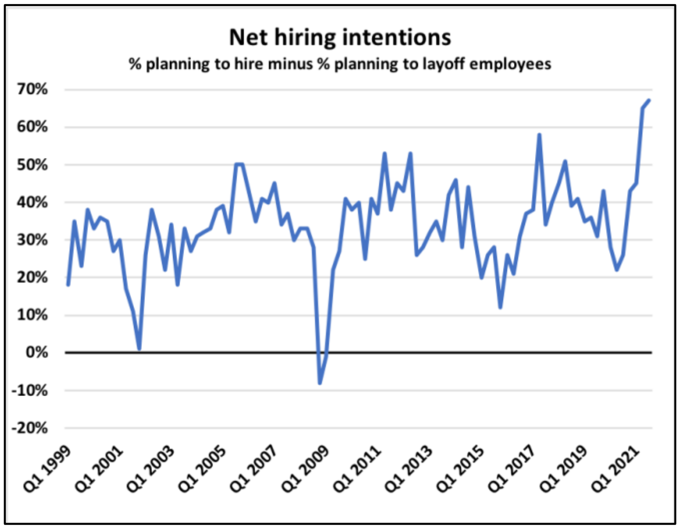




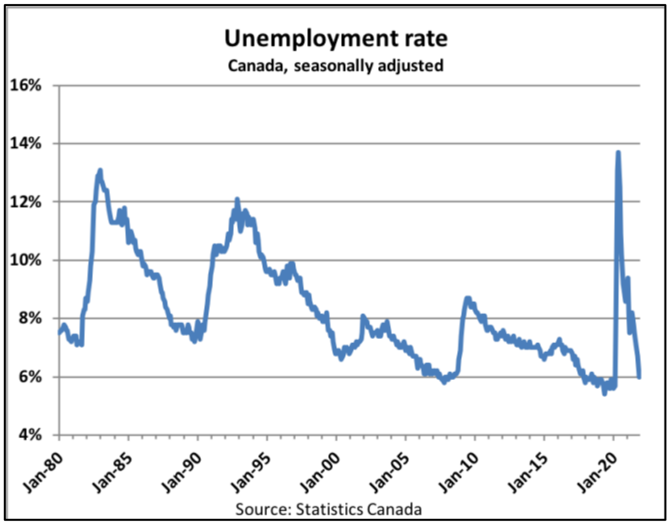
- There are now over a MILLION job openings across the country and an unprecedented 6% job vacancy rate.



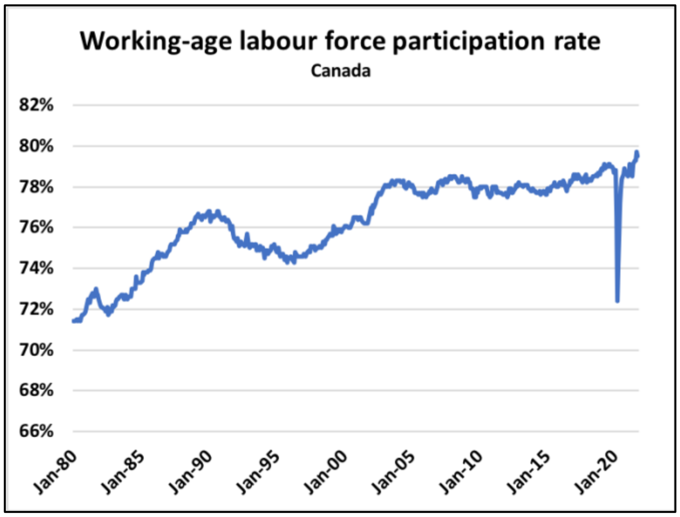
- The Bank of Canada's latest Business Outlook Survey showed the strongest net hiring intentions among businesses since the late 1990s.



- The unemployment rate plunged to 6% in November, more than a percentage point below the decade average and closing in on the record low of 5.4%:



- The working-age participation rate hit record highs in recent months, which means the share of 15-64 year olds who are employed or actively looking for work has never been higher:



Putting it all together: record hiring intentions, an already record shortage of labour, and a participation rate that is as high as it's ever been. **<u>Where exactly are the workers going to come from to fill these positions?</u> Employers will have to start competing hard for the existing pool of labour, and that should lead to strong wage growth in coming quarters.**

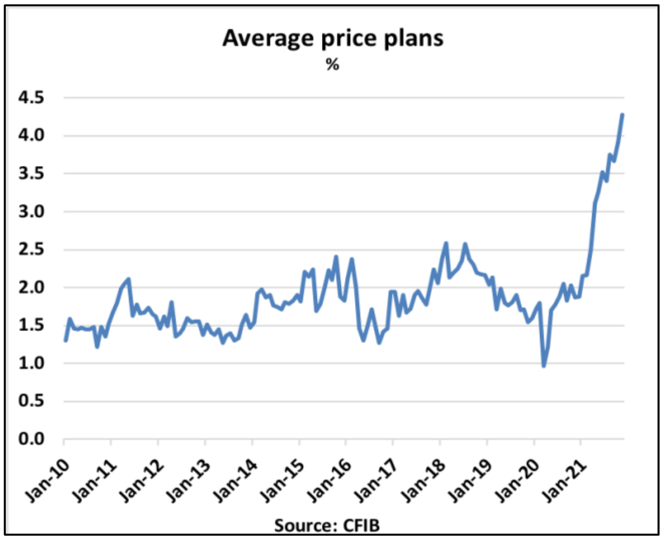
Already businesses are anticipating raising wages by the highest amount since at least 2010 according to CFIB:

The anecdotes on the ground largely confirm that it's already happening. From Global News[1]:

> […] "I'm seeing increases in labour wage rates anywhere from 10% to 40%," said Tanya Cerniuk, head of sales for Canada at global staffing firm Adecco Group.
>
> "I saw one today … they were offering C$14 an hour and now they're offering C$19.50 per hour," she said.
>
> "Things are changing so quickly. Employers are having to be very agile."

7) Inflation fears will peak but CPI will remain above BoC target band

Core inflation may accelerate for a few more months based on business pricing plan surveys and surging raw material input costs…



[1] https://globalnews.ca/news/8332153/wage-inflation-bank-of-canada//

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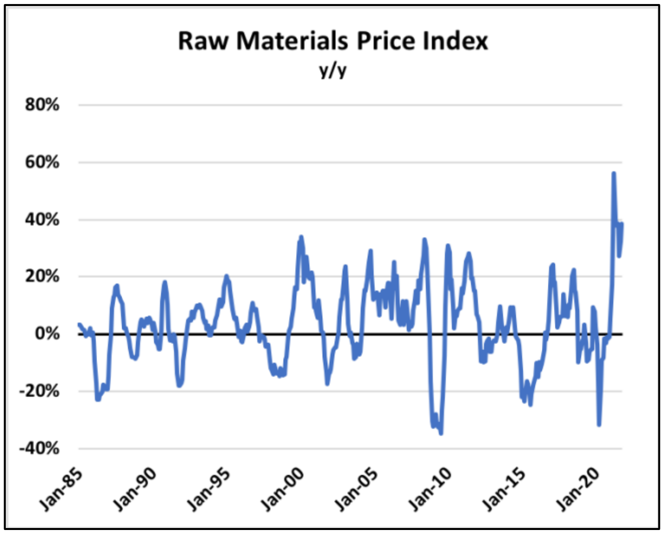
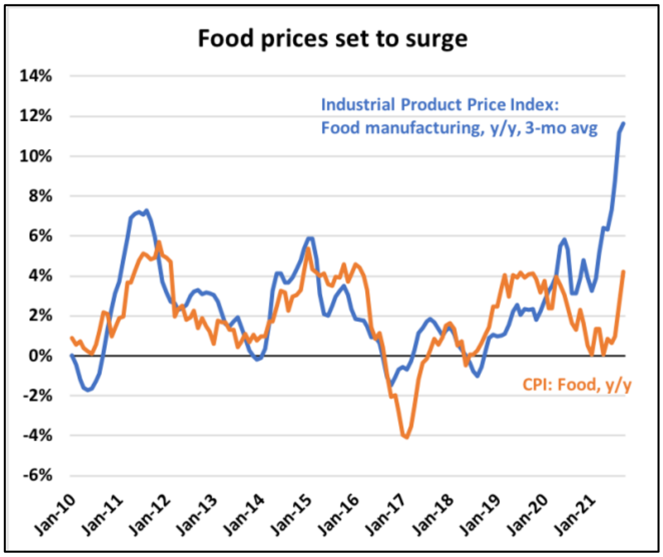
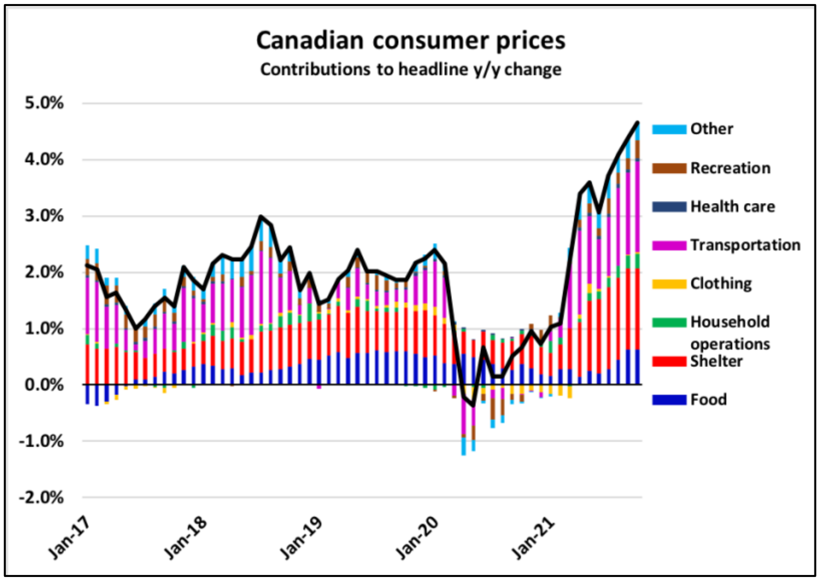


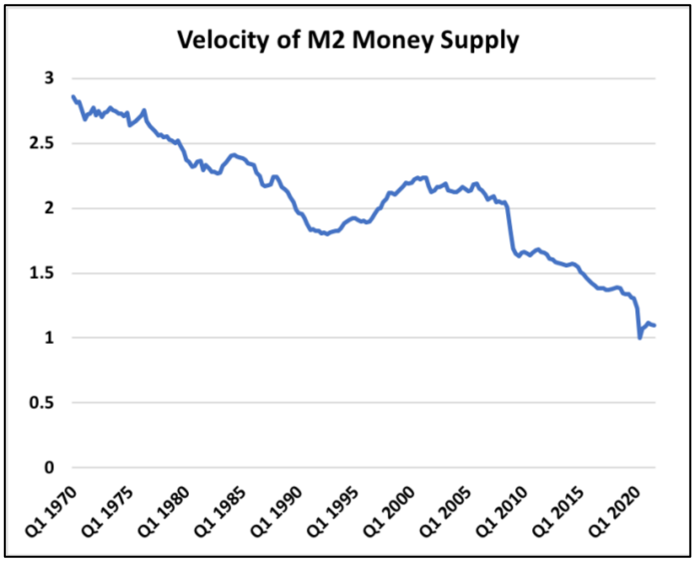
Meanwhile food prices, which haven't been a major contributor to headline inflation, are likely to jump meaning fully from here.



…But unless wage growth really gets crazy, we'll still likely see headline inflation peak in Q1. Transportation and shelter continue to drive much of the headline gains, and from a pure rate of change basis, those set up for difficult comparabales in 2022. It's unlikely, for example, that we'll see another 25% y/y increase in housing and 40% increase in gasoline prices next year:



We're also seeing a sharp slowdown in money supply growth, with M2 expanding at just 0.2% m/m seasonally adjusted in September, the weakest reading of the year. And velocity of the M2 supply has rolled back over and resumed its secular decline:

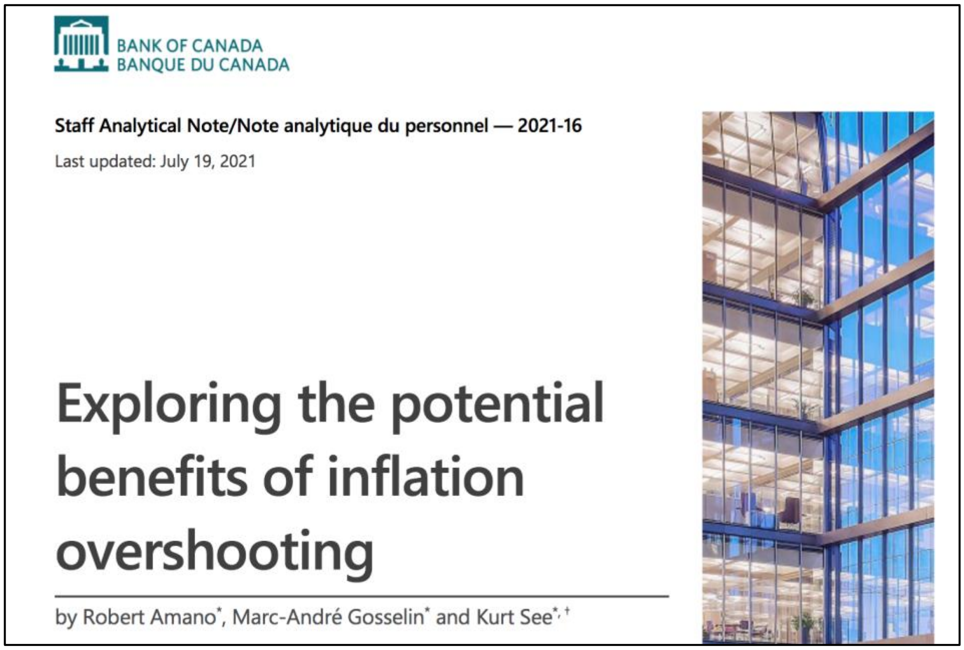


That said, I expect headline inflation will still remain above the upper boundary of the BoC's target band of 1-3%, but that's not likely to translate into the sort of rate hikes markets are currently expecting.

8) BoC will hike twice in 2022 but borrowing rates will stay negative in real terms

Strong wage growth and persistently high inflation SHOULD mean a much more hawkish central bank. And while I think it's reasonable to expect a couple hikes next year, I think the calls for 8 or more hikes by the end of 2023 are a tad aggressive.

For starters, the Bank has already hinted strongly that their reaction function will be different this cycle than prior. This analytical paper from July, which included input from BoC heavy weights Schembri and Wilkins, couldn't be more clear:



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Staff Analytical Note/Note analytique du personnel — 2021-16

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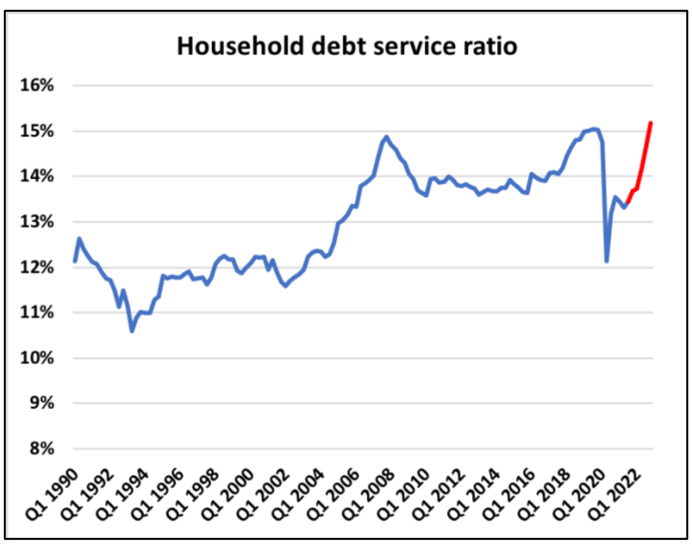
Exploring the potential benefits of inflation overshooting

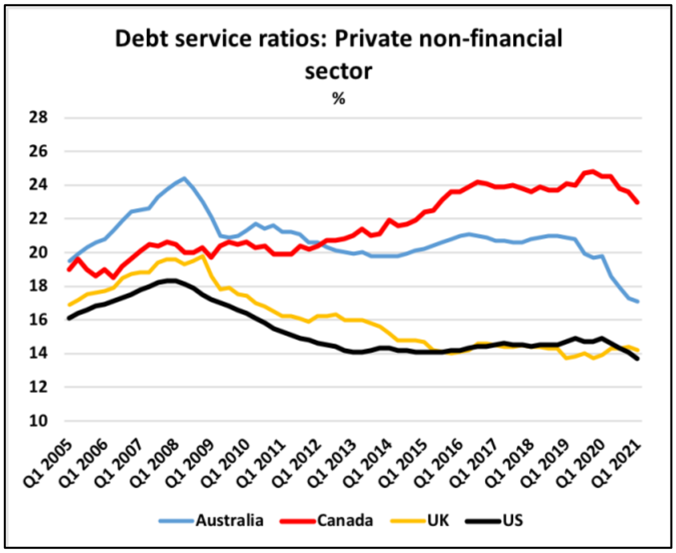
by Robert Amano[*], Marc-André Gosselin[*] and Kurt See[*,†]

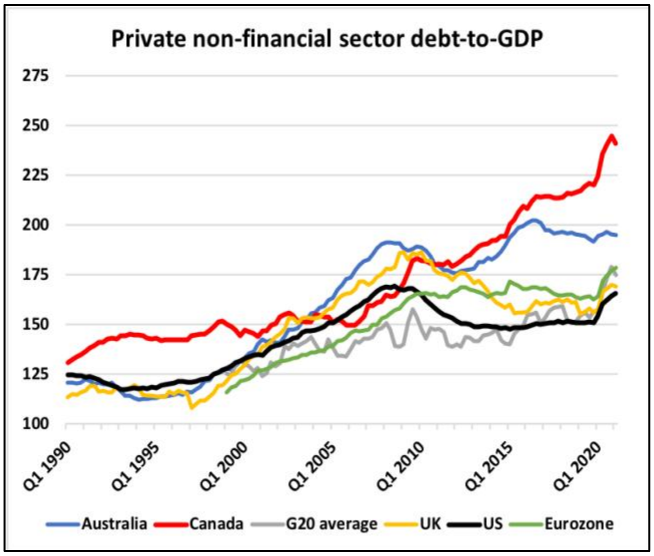
But the bigger issue is the leverage embedded in the Canadian economy. If we look at the household debt service ratio and make some conservative assumptions regarding aggregate income growth (1% per quarter) and debt growth (1.5% per quarter) and then model out an 80bp rise in the effective interest rate…which is about the flow-through in one year from a 125bp hike, we would hit new all-time highs by early 2023:



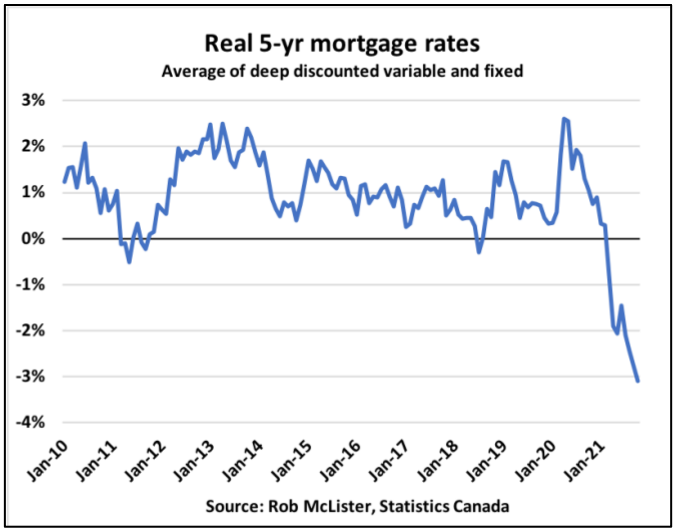
Now if income growth really takes off, it will certainly help. As will the record pile of household savings that would act as somewhat of a buffer. <u>But this would still slam the brakes on consumption and residential investment which combined have accounted for nearly 83% of real GDP growth over the past 5 years.</u>

And that's just households. Add in non-financial businesses and we end up with a combined debt service ratio of 23% and total debt to GDP equivalent to 240%…66 points above the G20 average.



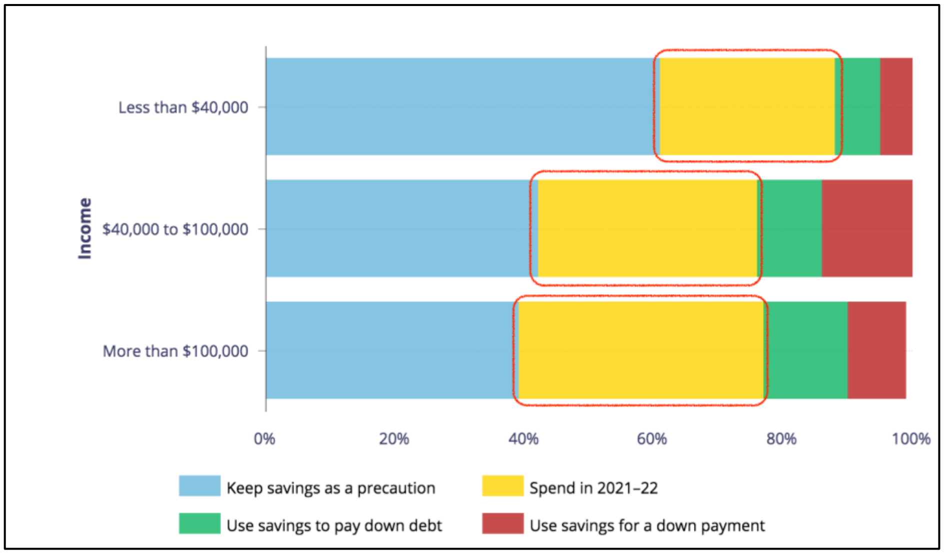


That degree of leverage will act as brakes on any BoC tightening cycle. Financial repression is the name of the game here, and I fully expect to see borrowing costs for households remain below headline inflation through next year:



9) Consumer spending will remain firm but risks are rising for 2nd half slowdown

Household consumption looks solid heading into the new year. The most recent Bank of Canada Survey of Consumer Expectations found that Canadians on average are looking to spend on the order of 35% of their roughly $250B in excess savings in late 2021 and early 2022:

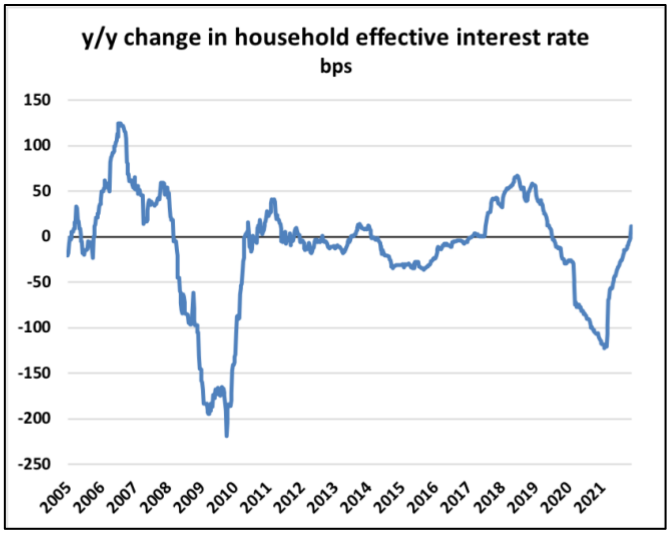


And with credit still flowing, confidence holding up well, incomes gaining steam, and the asset side of household balance sheets looking solid, there's no reason to think that wealth effect spending won't drive big ticket expenditures for a couple more quarters.

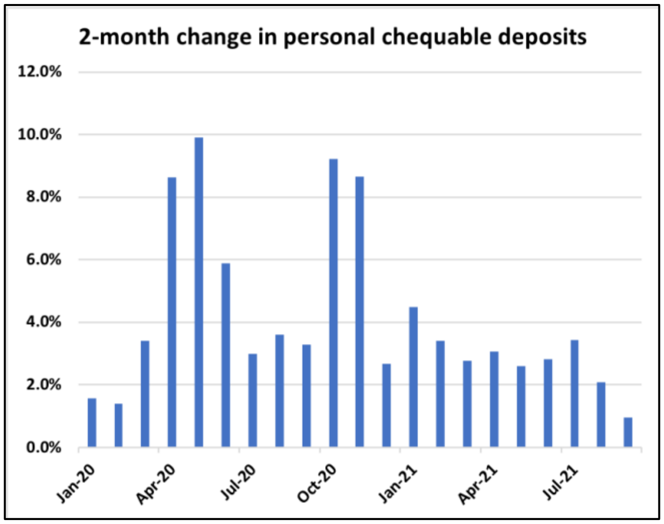
Let's also not forget that with the savings rate still in the double digits, there's plenty of room to divert savings to support consumption going forward.

Where things get a little more challenging is in the second half of the year as any potential rate hikes flow through to households.

Already the household effective interest rate is up 11bps y/y….the steepest increase since May 2019. And that's before any moves from the BoC.



There are also signs that the savings glut is finally abating, and within a few months we'll likely see households begin to draw these down. Take, for example, the change in personal chequable deposits at chartered banks. These surged throughout the pandemic but have flattened out in the past couple months to post the lowest increase since late 2019.



10) Delinquencies and insolvencies will bottom in Q1

Consumer credit trends remain abnormally strong due to a number of factors. The more normal, cyclical factors include low rates, solid employment trends, and huge housing gains which allow for refinancing (less than 1% of insolvency filings in Ontario involve homeowners):

But temporary factors are also at play:

- Continued income support measures from the federal government.
- Ongoing court delays in obtaining judgements.
- Work from home creates logistical issues with garnishing wages, both in terms of physically filing with the courts and serving employers.

It's likely that we'll see insolvencies and credit card delinquencies bottom in Q1 and begin to normalize. There are still 1.3 million Canadians receiving some form of employment insurance, but that figure is plunging as key recovery programs roll off.